WORLD TRADE

Time for another round

The world's current economic troubles strengthen the case for a new round of world trade talks, says Patrick Lane

AT A birthday party in Geneva, revellers are celebrating the 50th anniversary of the General Agreement on Tariffs and Trade (GATT), and a local television crew is making a documentary about the World Trade Organisation (WTO), the GATT's successor. The film might have featured grey-suited trade ministers congratulating each other on 50 years of trade liberalisation, but instead the camera captures a colourful crowd of demonstrators on the far side of rolls of barbed wire. They denounce the organisation and all its works. Free trade, they claim, despoils the environment and enslaves dispossessed peoples. "God is dead," reads one banner; "The WTO has replaced Him." Most of them protest peacefully, but a few start throwing stones and bottles, then overturn cars and set them ablaze.

It would be easy to dismiss the protesters as cranks. After all, the WTO has plenty to celebrate. Global trade has grown 16-fold since 1950 (see chart 1, next page), far outstripping the growth in GDP. It is freer than at any time since before the first world war, and possibly freer than ever. The WTO is an increasingly popular club: its membership now stands at 132 (see chart 2, next page), with another 30-odd, including China and Russia, in the queue to join.

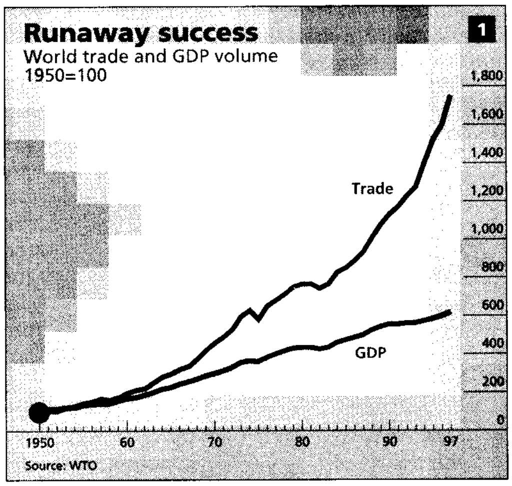
But the free-traders are not having it all their way. President Clinton has failed to win "fast-track" negotiating authority from Congress for new trade agreements, and is now distracted by other matters. Much more importantly, the global economic outlook has deteriorated from the merely worrying to the critical. Already the economies of Japan and much of Asia are shrinking. America, having enjoyed a prodigious boom for the past seven years, is slowing down and may yet tip into recession. If it does, the world economy will face its worst crisis since the Great Depression of the 1930s.

Mention of that awful decade should make politicians shudder. Then, governments responded to economic crisis by embracing protectionism, with disastrous results. This time should be (and so far is) different. There have been a few unwelcome signals—the odd tariff increase here, introduction of capital controls there—but as yet nothing like a retreat from free trade. Indeed, the strongest bulwark against a return to protectionism is the existence of the WTO itself: the GATT, after all, was set up after the second world war precisely to avoid a repetition of the economic follies of the 1930s.

The danger is that the global economic wobble will prompt politicians to scramble for shelter. Some American and European companies are already being overrun by competition from Asian goods, made much cheaper by drastic devaluations. If a global recession does come to pass and markets start to shrink, more businessmen and workers may demand protection from their governments.

This, therefore, may be an odd time to call for trade to be made freer still. Why rock the boat when the weather is stormy? And is trade not free enough already after half a century of liberalisation?

It is not. The lesson of the 1930s is that free trade, far from being a luxury affordable only when times



are good, becomes utterly essential when times are bad. This survey will argue that the time is ripe for a new round of global trade talks not in spite of but because of the current economic troubles.

The argument that trade is already free enough—or even, as some claim, "unfettered"—is unsustainable. Plenty of barriers to trade remain. Indeed, as conventional trade barriers, such as tariffs and import quotas, have come down over the past half-century, others, such as discriminatory regulations, have sprung up to take their place. Moreover, as the global economy has become more integrated, the meaning of "free trade" has become more elusive. Perhaps 20 years ago most trade negotiators would have settled for the definition in an elementary economics textbook: an absence of tariffs and quotas on goods. This will no longer do. Yet a more up-to-date definition is hard to pin down.

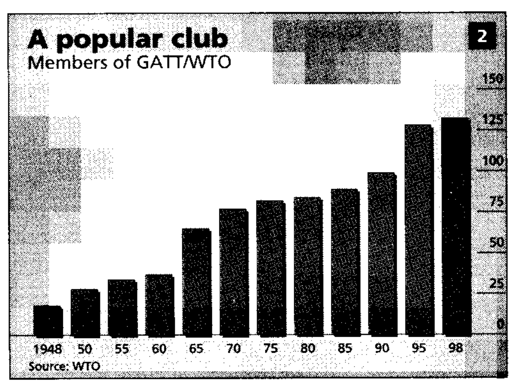
For a start, trade is not restricted to goods. Services too, from telephone calls to architects' plans, can be sold internationally. Instead of straightforward cross-border exchanges, the vehicle for trade in both goods and services can be foreign direct investment. Moreover, economists and trade negotiators realised long ago that barriers to trade are not confined to tariffs and quotas. National regulations can also thwart trade.

The Uruguay round of GATT negotiations reflected these changes in the nature both of trade and of trade barriers. The treaty to seal the round, signed in 1994, enormously increased the scope of trade rules. The WTO not only took over the old GATT, which dealt with trade in goods, but also took on new agreements on services, investment, intellectual property, technical barriers to trade, sanitary measures and plant health. Agriculture and textiles, sectors subject to extraordinary protection, were brought into GATT rules for the first time. The WTO also has a new system for settling trade disputes, with more teeth than that of the GATT. Since the end of the Uruguay round, agreements have been reached on trade in telecommunications, financial services and information technology.

The telecommunications deal is a good example of how trade and trade rules are evolving. It includes a commitment, made by most of the 69 countries that signed the deal, that telecoms regulators will be independent of suppliers. The idea is to prevent national monopolists from being both player and referee, and keeping out foreign competition. In effect, part of domestic competition policy has been subsumed into world trade rules.

However, the transformation of trade rules is incomplete. There are as yet no coherent rules to deal with either foreign direct investment or competition policy. Regional agreements on trade and economic integration have proliferated, prompting questions on whether these help or hinder global free trade. And plenty of trade barriers of the old-fashioned kind remain. Talks on liberalising trade in agriculture and services are already scheduled to begin in the next couple of years. There is easily enough work to justify launching a new round of global trade talks.

At the same time the spread of freer trade, and the success of the WTO, is causing friction between free-traders and defenders of ideas such as environmentalism and human rights. Until recently, the WTO has fought shy of confronting its critics. In preparing for a new round, trade ministers must also tackle these political problems. This survey will offer some suggestions on how they might set about it.



Why trade is good for you

A short tour of economic theory

ECONOMISTS are usually accused of three sins: an inability to agree among themselves; stating the obvious; and giving bad advice. In the field of international trade, they would be right to plead not guilty to all three. If there is one proposition with which virtually all economists agree, it is that free trade is almost always better than protection. Yet the underlying theory is not readily understood by non-economists. And the advice that follows from it—protection does not pay—is seldom wrong.

The argument for free trade is based on the theory of comparative advantage. This is one of the oldest theories in economics, usually ascribed to David Ricardo, an Englishman who wrote in the early 19th century. To see how it works, imagine two countries, East and West, which both produce two kinds of goods, bicycles and wheat. In a year, an Eastern worker can make two bikes or grow four bushels of wheat. A Westerner, however, can manage only one bushel or one bike. Each country has 100 workers, and initially both of their workforces are split evenly between the two industries. So East produces 200 bushels of wheat and 100 bicycles, whereas West produces 50 bushels and 50 bikes (see table 3, first panel).

Since East can produce both wheat and bicycles more cheaply than West, it has an absolute advantage in both industries. Even so, Easterners will benefit from trading with Westerners. This is because East is relatively more efficient at growing wheat, where it is four times as productive as West, than it is at making bikes, where it is only twice as productive. In other words, it has a comparative advantage in wheat. At the same time, West has a comparative advantage in making bikes, even though it has no absolute advantage in anything.

According to Ricardo's theory, both countries will be better off if each specialises in the industry where it has a comparative advantage, and if the two trade with one another. Specialisation increases world output. Suppose that East specialises in wheat growing, shifting ten workers from its bicycle factories to its fields, and producing 240 bushels and 80 bikes. West moves 25 workers from wheat farming into bike making, where its comparative advantage lies, and produces 75 bikes and 25 bushels. Global production rises (see second panel).

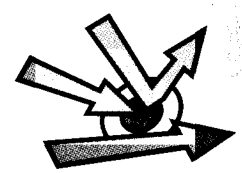
The point of economic activity, however, is not to produce but to consume. Both countries can enjoy more bikes and more wheat if they trade on terms at which both will gain. If East is going to import bikes, it will pay no more than two bushels in return (faced with a higher price, it would be better off moving workers back to the bike factory). Similarly, West will pay no more than one bike per bushel. Suppose that the "terms of trade", as economists call the ratio of export to import prices, are set at one-and-a-half bushels per bicycle, and that 33 bushels are traded for 22 bikes. The result (third panel) is that both countries are better off.

Comparative arithmetic 3

Autarky	Wheat	Bicycles
East	200	100
West	50	50
Total	**250**	**150**
Specialisation	**Wheat**	**Bicycles**
East	240	80
West	25	75
Total	**265**	**155**
Trade	**Wheat**	**Bicycles**
East	207	102
West	58	53
Total	**265**	**155**

In essence, the theory of comparative advantage says that it pays countries to trade because they are different. West's relative deficiency in bike manufacture is less than in wheat farming. It is impossible for a country to have no comparative advantage in anything. It may be the least efficient at everything, but it will still have a comparative advantage in the industry in which it is relatively least bad. And even if a country were the most efficient in every industry, giving it an absolute advantage in everything, it could not have a comparative advantage in everything. In some industries, its margin would be more impressive than in others.

Economists' next argument for free trade is that opening up markets to foreign suppliers increases competition. Without free trade, domestic companies may have enjoyed monopolies or oligopolies that enabled them to keep prices well above marginal costs. Trade liberalisation will undermine that market power. Competition should also spur domestic companies to greater efficiency because they will not be able to pass on the costs of slackness in higher prices.



In addition, free trade means that firms are no longer limited by the size of their home country, but

An angelic mix

ECONOMIC theory strips the world of its complications in the hope of making sense of it. Real life is a lot messier, but economic theory can still help to explain it. Take a look, by way of illustration, at the trading activities of one city, Los Angeles, and the forces that have shaped it.

• **Luck.** LA's best-known export is films. Nowadays, this is easy enough to explain in terms of comparative advantage. California's lead in movie making is enormous. Initially, good light and fine weather may have helped, but other places had those too. Luck, a hundred years of practice and economies of scale probably mattered more.

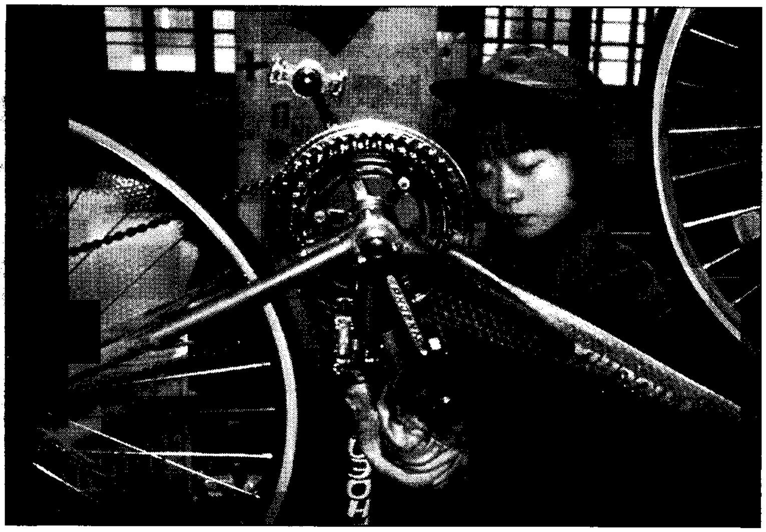
• **Geography.** Thanks to a deep harbour on the Pacific coast, the twin ports of Los Angeles and Long Beach are the busiest in America and the third busiest in the world. Moving containers in and out of the ports and to and from the rest of America is a big business in itself. The Port of Los Angeles reckons that it supports over 250,000 jobs in southern California—more than one in 24 of the region's total.

• **People.** LA's location helps explain its rich ethnic mix. Besides Latinos, whites and blacks, this includes Chinese, Koreans, Vietnamese, Japanese, Indians and many others, creating an intricate pattern of international commerce. Linking up all these different networks can create further business. In El Monte, one of the LA conurbation's 88 municipalities, John Leung of Titan Group, a property company, plans a business park aimed at helping small LA companies find their way into international trade.

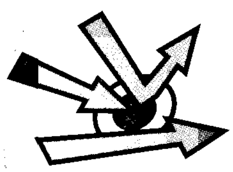
• **Technology.** The days when raw materials were produced in one country and turned into finished goods in another are long gone. The making of even the simplest goods is chopped up into a number of different stages, reflecting relative costs in different countries and falling international transport costs. Charlie Woo, chief executive of Megatoys, explains how a child's pinwheel, consisting of plastic sails pinned to a stick, is made in three different countries. The plastic is produced in America and cut to shape in China. The toy is then assembled in Mexico and shipped to LA for distribution.

• **Niches.** Some of LA's textile industry, explains Jack Kyser, a local economist, has gone south to Mexico in search of cheaper labour, but by no means all. Mexico is fine for run-of-the-mill jeans, but suppose that a smart department store quickly needs a new line of high-fashion dresses—perhaps just a few dozen, each selling for a few hundred dollars. A month or two later the style will be dead. The store might buy the dresses from one of the designers exhibiting in tiny spaces on 9th Street.

Many of those displaying here, explains Else Metchek of the California Fashion Association, are based in garages. Plenty more started up in them and moved on to greater things: one, launched 12 years ago, now turns over $85m a year. Even California style, however, has to accept a measure of globalisation. Knitwear production is so labour-intensive that it is moving abroad—not to Mexico, but to China.



Peddling comparative advantage



can sell into bigger markets. In industries where average production costs fall as output increases, producing economies of scale, this means lower costs and prices. In such industries, trade also increases the variety of products on offer. If a car manufacturer, say, were limited to its home market, it would have a choice between producing small quantities of a number of models and large quantities of just a few, which could be produced more cheaply thanks to economies of scale. But given free trade, it would be able to produce more models because they could all be produced in large enough numbers.

All these arguments revolve around re-allocating resources to produce one-off improvements—what economists call the "static" gains from trade. But they think there are also "dynamic" gains to be had: freer trade can mean faster economic growth.

In recent years, theories of economic growth have become much more sophisticated. Although economists have long realised that productivity growth is a prime determinant of general economic growth, models of growth in the past made no attempt to explain productivity growth, but assumed that it was "exogenous" (caused by outside factors). Modern "endogenous" growth theories, however, do try to explain productivity growth.

Freer trade can play a part in this in a number of ways. For one, by making markets bigger it creates more scope for "learning by doing"—ie, for firms to become more efficient with repetition. Larger markets also offer bigger incentives for firms to invest in research and development. Moreover, trade disseminates knowledge and technology. Simply by participating in international markets, countries are exposed to other countries' techniques, and have an incentive to copy and improve on them.

All this can make the relationship between trade, technology and growth quite complicated. For example, freer trade does not necessarily mean faster growth all the time. If a country's comparative advantage lies in slow-growing, traditional industries, it may cut back its production in other, faster-growing industries, so its growth rate may fall. But later on it will benefit from the technical advances of countries with a comparative advantage in faster-growing industries, which will give it better computers, more advanced drugs and so forth than if every country had tried to make everything for itself. Slower growth in the short run might therefore be balanced by faster growth in the long term.

Pinning down the link between freer trade and growth is not easy. One problem is how to measure the openness of a country's trade policy: trade barriers can take many different forms. Even so, there is good reason to believe that freer trade and faster growth generally go together.

Exceptions that prove the rule

So is free trade always the best policy? Not quite. One well-known exception is the "optimal tariff" imposed by countries that are big enough to exert an influence on the world prices of the goods they trade. By raising tariffs, they can significantly reduce world demand, cutting the world price of the good and tilting the terms of trade in their favour.

A second example, which came to prominence in the 1980s, is "strategic trade policy". In an industry with economies of scale, the imposition of a tariff, by reserving the home market for a domestic firm, allows the firm to cut its costs and, with luck, to undercut foreign rivals in overseas markets. Economists and politicians reckon that this might work in civil aircraft, semiconductors and cars.

However, it is rare for governments to be powerful enough to set optimal tariffs—and even rarer for them to have enough information to do so with pinpoint accuracy. They would need to be able to recognise a likely business proposition, and get their maths absolutely right. Even then, rival countries could follow suit, leaving them all worse off. ■

Border battles

Conventional trade barriers are coming down, but not quickly enough

THROUGHOUT eight rounds of GATT talks, tariffs were trade negotiators' staple fare (see table 4, next page). Only in the sixth, the Kennedy round, did the diplomats even begin to add other trade barriers to their diet. After half a century at the table, you would think, they must have made plenty of progress. And so they have; but it is surprisingly hard to say how much, and disappointingly easy to conclude that they still have a lot on their plates.

A commonly quoted statistic is that when the GATT was founded, developed countries' tariffs on manufactured goods averaged around 40%. According to the WTO, by 2000 that average will have tumbled to less than 4%. Most developing countries have further to go, but these figures convey the right message: trade has become freer over the past 50 years. At the same time the figures' precision is misleading.

In particular, it is hard to pin down a meaningful average tariff rate for the late 1940s. Outside the United States, tariffs at that time were not even the main barriers to international commerce. After the first GATT talks in 1947, *The Economist* sniffed that: "For many of the countries involved... customs tariffs are at present without any influence on the volume of trade." Currencies were not freely convertible, and imports were subject to licences and quotas. The trouble with quotas is that, once filled, they completely insulate domestic producers against foreign competition, and bestow monopolies on the importers that hold them. One of GATT's achievements was to establish tariffs as the least bad method of protection, and to negotiate maximum tariff rates (so-called "bound" levels). By now nearly all OECD countries have bound all, or almost all, of their tariffs.

Another reason for treating historical data with caution is that in GATT's early days most tariffs were "specific", ie, based on the volume of imports rather than their value. This, according to a paper by Douglas Irwin of Dartmouth College*, explains why America's average tariff rate looked far lower in the early 1950s (12%) than in the 1930s (50%). Four-fifths of that fall was due to inflation.

However, even today, measuring protection remains difficult. Quotas, licences and specific tariffs are still around. Although WTO members are committed to imposing tariffs on a "most-favoured-nation" (MFN) basis, which is meant to be non-discriminatory, in practice most of them do discriminate. Imports from partners in regional trade agreements are tariff-free. Developed countries levy special low tariffs on some goods from poor countries.

Even the MFN tariffs actually imposed may be far below the "bound" levels. Applied tariffs are therefore a better guide to protection than formal WTO commitments, but there is a risk that they may be increased abruptly. For example, Nigeria's bound tariff on most agricultural goods is 150%, and few industrial tariffs are bound at all; its applied tariffs now average 23%, but they have changed frequently in the past few years.

In addition, "average" tariffs can hide as much as they reveal. The measure used by the WTO is to weight tariffs by the share of goods in a country's imports. But if a tariff is pitched so high that it chokes trade altogether, its weight becomes zero, which is clearly nonsense.

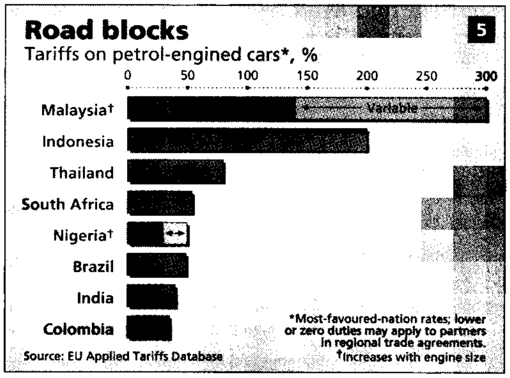
The OECD's annual survey of trade barriers† uses several different weighting systems, none of them perfect. Under one, tariffs are weighted by the shares of goods in the domestic production of the importing country, but this gives too much weight to highly protected products. In another, the simple average of all tariffs is used unweighted, which means it takes no account of the relative importance of different goods. In a third, the import weights used are OECD averages rather than the country's own. Yet OECD countries often protect the same industries, depressing their weights across the board. Even among developed countries, which tend to have lower tariffs than developing ones, the use of different weights can yield markedly different results. In 1996, estimates the OECD, Canada's import-weighted average tariff was 5.7%, its simple average was 9.2% and its production-weighted average was 12.1%.

What GATT did 4

GATT rounds

Date	Venue/name	Subject
1947	Geneva	Tariffs
1949	Annecy	Tariffs
1951	Torquay	Tariffs
1956	Geneva	Tariffs
1960-61	Geneva (Dillon round)	Tariffs
1964-67	Geneva (Kennedy round)	Tariffs and anti-dumping measures
1973-79	Geneva (Tokyo round)	Tariffs, non-tariff measures, "framework" agreements
1986-94	Geneva (Uruguay round)	Tariffs, non-tariff measures, rules, services, intellectual property, dispute settlement, textiles, agriculture, creation of WTO, etc.

Source: WTO



No matter which weighting system is used, averages tell you nothing about extremes. In manufacturing trade high tariff rates, or spikes, are less common than they used to be, but even in developed countries they still persist. For example, trucks attract a tariff of 25% in America and 22% in the European Union. High tariffs in the food industry often reflect heavy protection for agriculture. America's tariff on peanut butter is 132%; the EU slaps anything between 46% and 215% on fruit juices.

Developing countries can be spikier still. Malaysia's average import-weighted applied tariff fell from 15.2% in 1993 to 8.1% last year; well done. But tariffs in agricultural goods and car manufacture can go up to 145%, on top of licensing restrictions. Many developing countries make heavy use of high tariffs to protect their car makers (see chart 5).

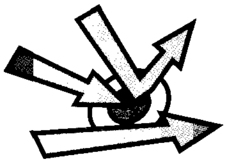
And so to work

All of this suggests that the WTO still has plenty of tariff-cutting to do. The best place to start would be manufactured goods. In developed countries, the tariffs on some of them are so low that they are barely worth collecting. They should be scrapped. In developing countries, average levels still have a long way to go—Mercosur's common external tariffs, for example, range up to around 20%. And there are plenty of spikes that need blunting.

The WTO also has to sort out textiles and agriculture, two of the world's most protected industries. The Uruguay round brought both of these under the

* "Changes in U.S. Tariffs: The Role of Import Prices and Commercial Policies". *American Economic Review*, September 1998

† "Indicators of Tariff and Non-Tariff Trade Barriers". 1997 edition



same trade rules as other goods. That this counts as an achievement is a measure of how bad things were, and are. Although the agreements created the basis for further negotiation, they did little to reduce protection.

Until the Uruguay round, much of the world's trade in textiles and clothing was governed by the Multifibre Arrangement (MFA), a cat's cradle of bilateral import quotas. Under the new textiles agreement, these quotas are being increased and items covered by the MFA are gradually being brought under GATT rules. "Gradually" is the operative word. At the start of 1995, WTO members shifted items ac-

Feel the width of those textile quotas

counting for 16% of their 1990 imports into the new system. Another 17% followed at the beginning of this year. A further 18% is due to move over in 2002, and the rest follows in 2005.

To slow things down further, importing countries (mostly developed ones) chose to start the transition from the MFA to the GATT with items on which quotas were not fully used. In the early years, therefore, it makes very little difference. And even when all the quotas have gone, trade will be no more liberal than at the outset, because high tariffs will remain. The United States, for instance, levies tariffs of between 14% and 32% on most synthetic, woollen and cotton clothing. A $25 pair of leather shoes imported into Japan attracts a tariff of 160%. No wonder that developing countries, which tend to be textile exporters, feel short-changed—even though their own markets are rarely monuments to open trade.

In much the same way as the textiles agreement, the Uruguay round's agreement on agriculture brought farm trade under GATT disciplines for the first time. In a useful recent study*, Timothy Josling, an economist at Stanford University, lucidly explains the fiendishly complicated results. The agreement did three things. First, with a few temporary exceptions, it converted all non-tariff barriers and unbound tariffs into bound tariffs. These tariffs have to be cut by an unweighted average of 36% between 1995 and 2000. Second, it prohibited new export subsidies and cut existing ones. And third, it began to tackle the domestic subsidies which, in effect, protect farmers against foreign competition in much the same way as tariffs.

This provides the starting point for new negotiations, due to begin next year. There is plenty to talk about. Some of the tariffs that have taken over from quotas are clearly set at a level designed to stop trade altogether: 300% on butter in Canada, 550% on rice in Japan, 215% on frozen beef in the EU, 179% on sweet powdered milk in America.

Further liberalisation, argues Mr Josling, is urgently needed, not only because tariffs and subsidies remain high but because the countries trying to join the WTO include big agricultural producers with large state-owned enterprises, such as China and Russia. There are some promising signs. In its recent Farm Act, America took another step towards uncoupling support for farmers from production subsidies. American farmers, keen to export, have been lobbying for a renewal of fast-track negotiating authority. In the EU, meanwhile, the prospect of enlargement to the east is increasing the pressure for reform of the common agricultural policy.

Then again, the difficulties should not be underestimated. If farm prices were to tumble, both America and Europe might be loth to relinquish export subsidies, which in recent years have been kept down by firm markets. America's sugar, dairy and peanut farmers have so far held on tenaciously to protection, and will try to go on doing so. Europe, too, can still muster plenty of opposition to free farm trade. Agriculture nearly scuppered the Uruguay round altogether. It seems more than capable of disrupting the next one.

* "Agricultural Trade Policy: Completing the Reform". Institute for International Economics, Washington, DC, April 1998

Trade by any other name

Does the WTO need special rules for foreign direct investment?

THE growth of international trade is not the only, or even the most impressive, measure of recent global economic integration. Between 1990 and 1997 the value of goods crossing international borders grew by just under 60% in dollar terms, whereas foreign direct investment (FDI) over the same period nearly doubled. Most of this investment went from one OECD country to another, but a growing share is now going to developing countries, mainly in Asia (see chart 6, next page).

Time was when economists considered FDI as a substitute for trade. Building factories in foreign countries was one way of jumping tariff barriers, which helps to explain the presence of foreign car manufacturers in countries from Brazil to South-East Asia. But these days economists are just as likely to think of FDI and trade as complementary.

For example, a firm can use a factory in one country to supply neighbouring markets. Ring Gateway 2000, an American computer company, from anywhere in Europe, and your call will be answered (and your order assembled) in premises near Dublin airport. A lot of FDI is also explained by the trend towards splitting up manufacturing among several countries. America's official statisticians estimate that one-third of all their country's trade takes place within companies. And some investments, especially in service industries, are essential prerequisites for selling to foreigners. Who would buy a Big Mac in London if it had to be sent from New York?

All this raises two questions. First, why should governments treat FDI, and the trade associated with it, any differently from other kinds of trade? Answer: in principle, they should not—although in practice the issue is hotly disputed. Second, what is the equivalent for FDI of free trade? The answer to that is more complicated—and just as hot politically.

Put out the welcome mat

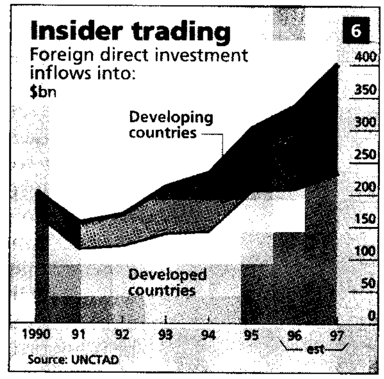
Edward Graham, an economist at the Institute for International Economics, a Washington think-tank, suggests some criteria, similar to existing WTO rules on trade in goods. One is "national treatment". In the GATT, this means that imports, having crossed the border, should not be subject to special taxes or other forms of discrimination. For FDI, however, there could be a weak or a strong version of national treatment. Under the weak one, foreign investors, once established, would be treated the same as locally owned companies. Under the strong version, foreigners would also have the same right of establishment as locals. This is the FDI equivalent of zero tariffs.

In line with another GATT doctrine, says Mr Graham, foreign investors should have "most-favoured-nation" status: host governments should not discriminate among investors from different countries. There should also be a forum for settling disputes. If the host government were to default on its commitments, investors should be able to seek redress before special tribunals or national courts. This would be a change from the WTO's existing procedures, in which the only plaintiffs and defendants are governments.

Existing WTO rules on investment give foreign investors far fewer rights than these. The current rules were laid down in three separate Uruguay round agreements. The first, the Agreement on Trade-Related Investment Measures (TRIMS), deals only with investment in manufacturing. It stops governments from requiring investors to use a minimum level of local inputs, and to export at least as much as they import.

The second, the General Agreement on Trade in Services (GATS), recognises "commercial presence" (WTO-speak for setting up shop) as one of the ways in which services are traded, but it does not oblige WTO members to throw open all their service industries to all comers. Although they must subscribe to its general principles, they need open up only those industries listed in their "schedules of commitments". In many cases, these lists are pretty short.

The third, the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS), obliges WTO members to grant minimum periods of protection to copyrights, patents and trade marks. Developing countries have more time than rich ones to bring their laws into line. The TRIPS agreement protects foreign investors by stopping locals from pinching their inventions and brands.

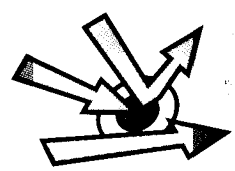


The chances of creating a single FDI accord incorporating Mr Graham's criteria look slim. True, the principles he outlines are already enshrined in regional trade agreements and some of the 1,600 bilateral investment treaties (BITS) signed so far. Companies established in one EU country are free to go wherever they like within the Union. The North American Free-Trade Agreement allows investors to take host governments to tribunals, but the few cases that have been brought so far have proved controversial.

Moreover, the OECD's efforts to build a multilateral investment agreement (MAI), seen by some as a springboard for a WTO agreement, stalled earlier this year. Governments have been unable to agree on how far investment should be liberalised. Environmentalists, trade unions and other non-governmental organisations denounced it as a multinationals' charter that would leave governments powerless to protect either workers or the planet. That scared politicians into retreat.

The OECD deal, on which talks are due to resume soon, might not be worth much anyway. Most OECD countries already have liberal FDI regimes, and the MAI would not have addressed their biggest sin: the huge subsidies they shell out to attract foreign factories. Even so, the MAI's troubles do not augur well for a WTO agreement.

On top of this, many developing countries are opposed to any FDI deal at the WTO. Manmohan Singh, the finance minister who began India's economic liberalisation in the early 1990s, explains that several BITS have been signed granting national treatment to foreign investors, but that: "We are not ready as yet for right of establishment. You have to remember our history as a colony. The East India Company came here as a trader and ended



Making FDI palatable

Brittan disagrees

up owning the country."

So what should governments do? America still favours persevering with the OECD talks. "It's a little premature to say it won't produce anything. It may produce a lot," says Charlene Barshefsky, the United States trade representative. But Sir Leon Brittan, the EU's trade commissioner, who has long been pressing for a WTO accord, disagrees. "The difficulties of the MAI should make the climate more propitious," he says. "Among developed countries, there's been a feeling that although we'd like to talk at the WTO, let's not get in the way of the MAI." By way of reassurance to developing countries, Sir Leon stresses that he is not proposing an investment free-for-all.

Given the way trade negotiations work, a WTO deal of some sort is not impossible. India's reluctance might be overcome if, say, rich countries moved smartly to open their textile markets. And a free-for-all could be avoided by an agreement similar to the GATS, in which governments settled on general principles but opened up sector-by-sector.

The larger question is whether a WTO agreement on FDI is worth pursuing. These days, governments that were once suspicious of foreign investors are welcoming them with open arms, especially in manufacturing. They hope that investors will bring expertise and technology that will be passed on to local firms and workers, helping to sharpen up their whole economy. Foreign investors, for their part, have needed no prompting to pour money into factories in developing countries, especially China. And where FDI is not forthcoming, as in sub-Saharan Africa, investors are unlikely to be swayed by the reassurance offered by a WTO accord.

Open wider

However, argues Bernard Hoekman, an economist at the World Bank, there are still important barriers to foreign investment in service industries. He reckons that under the GATS, rich countries agreed to open about half of the service industries covered by the agreement, but developing countries managed only one-sixth—and in many of these markets the opening was less than complete.

In failing to liberalise services, governments are harming their own economies. Services such as transport and telecommunications are vital for the efficient functioning of the rest of the economy. Indeed, write Mr Hoekman and Carlos Primo Braga, another World Bank expert, in a recent paper*, protecting service industries can undo the benefits of liberalising goods trade. Cutting tariffs will expose manufacturing industries to foreign competition, but if poor roads, railways and other communications stop goods from getting to market quickly, those manufacturers will be hobbled.

Just look, say the two authors, at the gains Chile reaped from liberalising its merchant shipping industry. Increased competition spurred the introduction of new technology, such as refrigeration, which helped Chile to become a successful exporter of salmon and kiwi fruit. By contrast, the United States is paying dearly for the Jones Act, which restricts shipping between American ports to American-flagged ships. This has pushed freight rates to between twice and four times what they would be under free trade.

Moreover, foreign investment in services may bring more skills into host economies than investment in manufacturing, because goods production is more easily split into its constituent parts than services production. A manufacturer might set up a "screwdriver" plant in Mexico while keeping its research and development department in America and its high-tech component factory in Europe. But a company running hotels or selling banking, insurance or telecoms services will have to train local hoteliers, bankers, insurers and telecoms engineers.

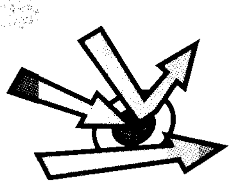
That advantage may not last. In time, telecommunications technology will develop to the point where more and more services can be traded across borders. There may no longer be a need for, say, an insurer to have an office in Caracas in order to sell to the Venezuelan in the street. The know-how can stay in New York or Zurich. That prospect should spur developing-country governments into action: liberalise now, or lose out.

If Mr Hoekman is right, then the WTO's best course might be to concentrate on further liberalisation within the GATS, rather than strive for a new across-the-board deal on FDI. Still, strengthening safeguards for investors in goods industries would be a welcome bonus.

* "Trade and Protection in Services: A Survey". *Open Economies Review*, 1997

Commerce and contestability

The marriage of trade and trustbusting

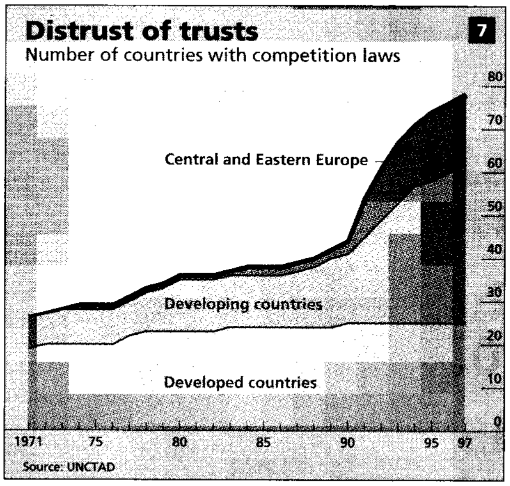


SUSPENDING disbelief, suppose that the world's governments had abolished all barriers to international trade, and allowed foreign investors to set up businesses on the same terms as their own people. Would free trade have arrived?

Probably not. Some markets would still not be open to competition, whether from home or abroad, either because as natural monopolies they could not support more than one supplier, or because entrenched monopolies and oligopolies would keep competitors out. Private barriers to trade might replace those put up by the state.

This is why in many countries the liberalisation of trade and FDI policies has gone hand-in-hand with the establishment of competition authorities. Since 1990, some 30 developing countries and former communist countries have introduced antitrust laws. In all, nearly 80 countries now have such laws (see chart 7, next page).

Yet the actions of a country's competition authority can affect foreign companies' ability to enter its market, or spill over into other countries' markets. Some economists and politicians feel that competition policies need to be more closely coordinated internationally; some, indeed, argue that since trade and competition policies have become so intertwined, the WTO should embrace competition policy as well.



Competition policies can spill over into trade in several ways. Examples include:

• **Aircraft.** A merger or alliance between two companies from the same country might affect competition in other countries. Thus American regulators were happy for Boeing, a giant manufacturer of civil aircraft, to take over McDonnell Douglas, an ailing smaller firm. But the EU's competition commissioner, Karel Van Miert, was worried that the merger would reduce competition in Europe, to the detriment of Boeing's European rival, Airbus, though in the end the deal went through.

• **Airlines.** A merger or an alliance between two companies from different countries might affect competition in the two markets in different ways. For example, American regulators nodded through the mooted alliance between British Airways and American Airlines because they felt it was unlikely to hurt competition at the American end of transatlantic routes. But Mr Van Miert, looking at the deal from a European angle, thought it would do some damage, and insisted that BA give up some take-off and landing slots at London's Heathrow airport.

• **Fortress Japan, as seen from Detroit.** A monopoly or group of companies in one market may be helped by slack competition policy to block entry by foreigners. Time and again in the past two decades, American businessmen have complained to the United States trade representative that the Japanese market was impossible to break into, despite low tariffs. In 1995, America came close to imposing punitive tariffs on Japanese luxury cars in retaliation against the exclusive ties between Japanese car makers and showrooms. It eventually backed down. In 1997, America lost a case at the WTO in which it had argued that Fuji, Japan's market leader in photographic film and paper, was keeping Kodak, America's number one, out of the Japanese market by controlling distribution and retailing.

• **International cartels.** Companies may collude to fix prices internationally, or agree not to compete in each other's markets. To fight this, several competition authorities may need to exchange information and act jointly.

• **Export cartels.** In some countries companies are allowed to form export cartels because the resulting higher prices will affect only foreign customers. In practice such cartels account for only a small proportion of trade, but there is a strong economic ar-

The Wired Trade Organisation

THROUGHOUT history, international trade has been helped by all manner of technical advances, from the development of the tea clipper to the invention of powered flight and the telecommunications revolution. The last of these, and especially the Internet, could have a huge effect on trade in the next few years.

Electronic commerce should boost trade in goods: hard-to-find books or music recordings, for example, have become easier to track down on the Internet. But trade in services should benefit even more. Anything that can be put into digital form will be tradable. For example, architects will be able to send and amend designs electronically. Doctors may be able to diagnose and dispense to patients abroad whom they never meet.

One of the best things about electronic commerce is that it is fairly free from interference by governments. America wants to keep it that way. It has called for a WTO accord on electronic commerce that would keep the electronic transmission of digitised information free of customs duties.

This looks like a trade diplomat's dream. In the absence of any barriers at present, nothing needs to be negotiated away. The WTO's agreement on trade in telecommunications services already guarantees the freedom of some aspects of electronic commerce. And a deal can almost certainly be done without fast-track negotiating authority for President Clinton.

•

Can you drop it on your foot?

Despite all these plus points, electronic commerce raises two difficulties for the WTO. First, it blurs the distinction between a good and a service. This matters because WTO rules treat goods and services differently. Goods tend to be subject to tariffs; services are not, but trade in services is limited by restrictions on "national treatment" or quantitative controls on access to foreign markets. So the rules that will be devised for electronic commerce may affect the choice between physical and digital methods of trade.

For example, a compact disc sent from one country to another is clearly a good, and will incur a tariff as it crosses the border. But if the music on the disc is sent electronically from a computer in one country to a computer in another, is it still a good, even though it can no longer be dropped on your foot? Customised data and software, which can also be put on CD, are usually treated as services. Who can tell?

Second, electronic commerce poses a headache for national regulators, especially in service industries such as medicine and financial advice where suppliers are much better informed than their customers. Watchdogs may be helpless to stop the electronic sale of quack treatments or dodgy investment schemes.

They could impose trade restrictions, insisting, for example, that financial firms selling on the Internet to residents of their country must also have an office there; or they could work more closely together, with officials in the seller's country monitoring cross-border sales on behalf of regulators in the buyer's country. But such invigilation would take away some of the Internet's free-wheeling charms. More sensibly, they might decide to leave well alone and let the buyer beware.

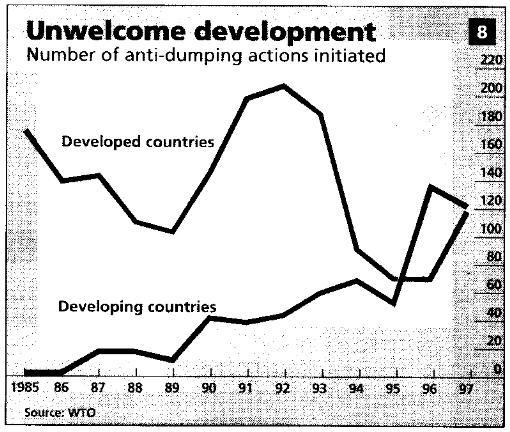
gument for outlawing them all.

The WTO is divided over how to deal with these problems. The EU is keen on a WTO agreement on competition policy. Its trade commissioner, Sir Leon Brittan, would like all the organisation's members to commit themselves to introducing effective competition laws, covering mergers, monopolies and restrictive business practices. These laws would have to meet minimum standards: proceedings would have to be transparent, and the rules would have to be backed up by sanctions. Domestic and foreign firms would have to have equal access to national courts.

By contrast, Joel Klein, the head of the antitrust division of America's Department of Justice, sees no value in a WTO agreement setting minimum standards. "I strongly suspect that nearly all of the world's 70-odd competition laws, accounting for nearly all important trading nations, would likely meet the requirements of any minimum substantive rules the WTO could adopt," he says. "So what is the point?"

The Americans also say that it would be very hard to agree on competition rules. In the Boeing case, for example, America and the EU read the same facts in different ways. The effects on the two markets were not all that different, because both Airbus and Boeing sell to both American and European airlines. Moreover, Americans and Europeans treat "vertical restraints", such as exclusive deals between retailers and manufacturers, in quite different ways. In the EU most such arrangements are illegal unless they have specific exemptions. In America each case is considered on its merits.

Mr Klein thinks there is more to be gained from bilateral arrangements between national competition authorities than from a WTO deal. In particular, he favours greater use of "positive comity", which allows a competition watchdog in one country to ask its counterpart in another to investigate anti-competitive practices on its behalf. The EU and America have had such a deal since 1991.



John Bull— "I say this is getting serious"

Yet when Mr Klein says there is "no point" in a WTO agreement setting minimum standards, he conveniently overlooks the fact that some 60 WTO members still have no competition policies at all. For those countries, some standards, however modest by Mr Klein's lights, would be better than none. And in the past GATT commitments have been treated not as an end in themselves, but simply as the starting point for further improvement. Just as GATT has brought down tariffs in the past 50 years, so the WTO could raise the standards of competition policy.

Whisper it not

However, there is one important link between trade and competition policies that neither America nor the EU wants to discuss. The unspeakable practice is anti-dumping. Under WTO rules, countries are allowed to impose anti-dumping duties on imports sold at below "normal value"—which can mean the price in their home market or the cost of production. The fact that the WTO permits anti-dumping may make it sound respectable. It very rarely is.

Its defenders say that it helps firms deal with "unfair" foreign competition, but in reality it is an arbitrary form of protection. The information from which "normal value" is calculated is often sketchy. Trade authorities listen to producers hurt by "dumping", but take no account of the views of consumers, who might well prefer cheaper goods. In a recent study* of anti-dumping petitions in America, the EU and Canada in the 1980s, Robert Willig, an economist at Princeton University, set out to establish whether the practice was justified on competition-policy grounds, and concluded that in more than 90% of successful petitions it was not.

In time, as developing countries make increased use of anti-dumping duties (see chart 8), the EU and America may become more inclined to talk about the subject. And if more countries adopt competition policies, the rationale for anti-dumping, already weak, will look flimsier still.

* "Competition Policy and Anti-Dumping". *Brookings Trade Policy Forum*, forthcoming

Alphabetti spaghetti

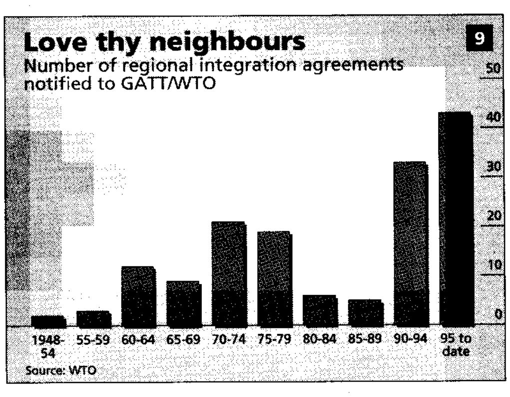
Are regional trade agreements a good idea?

DRIVING around the ever-spreading factories of Tijuana, Enrique Mier y Teran points to one foreign-owned plant after another: JVC, Sony, Messer Griesheim, all making goods for the American market. Then he stops between two factories. The one on the right, he explains, can export TVs duty-free to the United States because it uses tubes made in the one on the left. The one on the left is a product of the North American Free-Trade Agreement's "rules of origin": for a TV to enter America duty-free, some critical components—in this case, the tubes—must be made in NAFTA countries.

Mr Mier y Teran's tour neatly captures economists' ambivalence over regional trade agreements. Thanks to free trade between Mexico and the United States, Americans now import from their southern neighbours things that they used to make for themselves at greater cost. Economists call this "trade creation", and it is all to the good. Yet were it not for the rules of origin, the tube factory would have been somewhere else, probably in Asia. America imports those TVs, or at least the tubes inside them, from Mexico only because NAFTA discriminates against non-NAFTA goods. This is called "trade diversion", and it is not a good thing at all.

In the past few years, economists have had a great many regional agreements to scratch their heads over. Besides NAFTA, the Americas have seen the creation of Mercosur in the south, and one day a Free-Trade Area of the Americas may be born. The European Union, the grandmother of them all, has formed the European Economic Area with the remaining members of the European Free-Trade Association. It also has Europe Agreements with Central Europeans as well as deals with North African countries and Mercosur. In Asia there is APEC, the Asia-Pacific Economic Co-operation forum, which has a grand goal of "free trade in the Pacific by 2020" (but no formal trade deal at present), as well as the ASEAN free-trade area and ANZCERTA, a pact between Australia and New Zealand. All told, in the past 50 years 153 regional trade agreements have been notified to the GATT or the WTO, of which most are still in force. Almost half of these—some, admittedly, revisions of previous deals—have been set up since 1990 (see chart 9).

This deluge of alphabet soup has deeply divided economists. Even language has become an issue. Jagdish Bhagwati of Columbia University, perhaps their most vocal critic, insists on calling them "preferential" rather than "regional" or (heaven forbid) "free" trade agreements, lest anyone forget their trade-diverting effects.



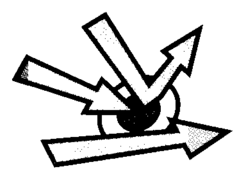
As international commerce has become more intricate, so have the arguments. For a start, regional deals do not take place in a vacuum; they affect the climate of global trade negotiations. But are they, in Mr Bhagwati's phrase, "building blocks" or "stumbling blocks"? The first, says Fred Bergsten of the Institute for International Economics. In the early 1980s, he recalls, the thought that America might embrace regionalism, previously anathema in Washington, shocked the EU into GATT talks. The

The genuine NAFTA article

same thing, he believes, happened in the 1990s: the rise of APEC persuaded the EU to bring the Uruguay round to a close.

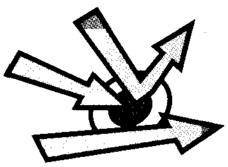
Mr Bhagwati agrees with Mr Bergsten's reading of the 1980s, but considers his view of the 1990s "fanciful". Politically, he thinks, NAFTA has made the liberalisation of trade between America and poorer countries more difficult. Contrast that with the Uruguay round, in which there was only mild political resistance to freeing America's trade with much poorer India.

A second complication is that manufacturers increasingly carry out different stages of production in different countries. It is this which gives rise to rules of origin. Regional agreements need to spell out whether, for example, a TV assembled in Mexico, which might contain components from all over the world, is Mexican enough to be allowed duty-free into the United States. This is a nonsense, says Mr Bhagwati. Preferential trade ageements create a "spaghetti bowl" of overlapping rules of origin that are sure to distort some investment decisions.



Third, as Bernard Hoekman of the World Bank describes in a recent paper*, regional agreements are pushing the definition of free trade beyond the

* "Integrating Domestic Policies". Unpublished



"national treatment" principle. Under national treatment, all goods and services, once inside the country, are subject to the same rules, regulations and taxes, regardless of their origin. Thus all companies are subject to the same antitrust and merger rules. Imported pharmaceuticals, food and electrical equipment, say, have to pass the same safety tests as those produced at home. Doctors and accountants must hold the country's professional qualifications to be able to practise.

Secret weapon

However, such rules can act as barriers to trade. Sometimes they are deliberately used in that way: for example, Mexico used to insist that imported American pigs be vaccinated against hog cholera, a disease that disappeared from the United States in the 1970s. But even if national rules are applied in all innocence, they can still gum up trade. Having been tested for safety at home, goods must be tested again before being sold abroad. Professionals have to take more exams before they can practise abroad. Some countries are now trying to get round these problems by harmonisation or mutual recognition of standards.

The prime examples of such agreements are to be found within the EU. In 1979, the European Court struck down a German ban on Cassis de Dijon, a French liqueur, imposed because of its low alcohol level. This established the principle of mutual recognition: that goods sold in one member state could be sold in all. As well as mutual recognition, in some fields the EU is pursuing harmonisation. For instance, products are subject to common minimum safety standards. National competition laws are supplemented by pan-European legislation. And a dramatic act of harmonisation is due to begin next year, when 11 countries will adopt the same currency.

Within other regional trade agreements, governments have also sought mutual recognition and harmonisation agreements, if not to the same extent as within the EU. Nevertheless, Mr Hoekman points out, a trade agreement is not a prerequisite for a deal on standards. The EU and America have recently struck such a deal even though there is no prospect of a transatlantic trade agreement. In several sectors, ranging from medical and electrical equipment to pharmaceuticals, the two sides have agreed that European organisations can test goods to American standards on behalf of American testing organisations, and vice versa. This falls short of mutual recognition, but is a step in that direction.

This kind of integration is often as much about politics as about commerce. Even so, harmonisation and recognition agreements can both create and divert trade. The new agreement between America and Europe should boost transatlantic trade in electrical goods, but the deal also gives American and European products an edge in each other's markets over goods from other countries. It is worth noting, says Mr Hoekman, that the EU is loth to negotiate mutual-recognition agreements with developing countries.

The WTO does have rules on regional agreements, but they are vague and out of date. Article XXIV of the GATT says that a regional deal must cover "substantially all trade" among its members. Define that if you can. It adds that barriers to nonmembers must not be raised. This is a weak test of trade diversion.

In 1996 the WTO set up a committee to examine regional trade agreements. It replaced a bunch of working parties on the compatibility of individual deals with Article XXIV. They rarely reached conclusions. Whether the new committee will be more incisive remains to be seen, but it seems unlikely to offer strong criticism of any regional group—if only because of the WTO's 132 members, all but three (Japan, Hong Kong and South Korea) are members of some regional trade club.

The trouble with regional deals is that they discriminate between their members and the rest of the world. The best thing the WTO can do to minimise the damage is not to try to unpick them, but to press on with multilateral trade liberalisation. The more progress it can make on that front, the less room there will be for discrimination.

Turtle wars

Greenery and globalisation do not mix

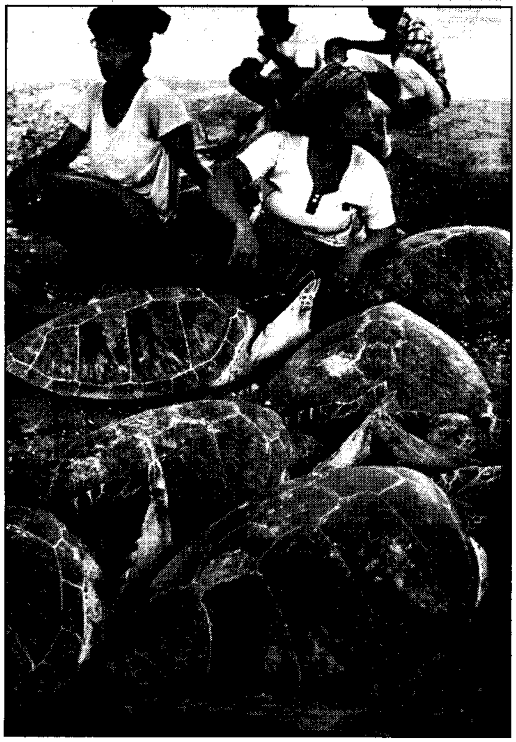
CESAR LUNA leafs through photographs of a "border reality trip" to Tijuana. Corroding drums of chemicals litter an industrial site open to the elements. There is nothing to keep children out, says Mr Luna, a campaigner with the Environmental Health Coalition in San Diego. Water runs down an escarpment towards people's homes below. He talks about heavy metals and acids contaminating the environment and damaging people's health: "We're not talking about skin rashes and cold sores, but serious long-term health problems."

Mr Luna explains that he is not against a "just" free-trade agreement between America and Mexico, but that in Tijuana some companies are getting away with far too much. The side accords to the North American Free-Trade Agreement, which oblige NAFTA countries to uphold their own labour and environmental laws, have no teeth.

Environmental campaigners such as Mr Luna are becoming more vocal in arguing that world trade is already too free for the planet's good. And if they are cross about NAFTA, they are hopping mad about the WTO.

They have two main complaints. First, a string of national laws aimed at protecting the environment or human health have fallen foul of the WTO's dispute-settlement panels, beginning in 1995 with the very first case to be heard by one of these tribunals. The way in which America administered its clean-petrol laws was held to discriminate against imports from Venezuela.

Since then, say the greens, things have got worse, citing two cases decided earlier this year. In the first, the WTO upheld a complaint by India, Malaysia, Pakistan and Thailand against an American law banning the sale in the United States of shrimps caught


Do not mock turtles

in nets that do not allow sea turtles to escape. Shrimp nets are the biggest killers of sea turtles, says Peter Fugazzotto of Earth Island Institute, a marine-conservation group in San Francisco. It was Earth Island that prodded the American government into taking up the turtle case. The second decision was that a long-standing EU ban on beef treated with growth hormones—ie, most American meat—was incompatible with WTO rules.

The environmentalists also fret that WTO rules may undermine some international agreements to protect the global environment (known as multilateral environmental agreements, or MEAS). Of the total of around 200 such MEAS, about 20 either ban trade in certain pollutants or in goods made using them, or permit the use of trade sanctions as tools of enforcement. For example, the Montreal Protocol bans trade in chlorofluorocarbons (CFCS), which deplete the ozone layer. This trade ban, says Duncan Brack of the Royal Institute of International Affairs in London, played a big part in persuading countries to sign the protocol and end CFC production.

Luckily, so far no government has challenged the trade provisions of any MEA, but that luck may run out. For instance, a country that has not signed the Basle Convention on hazardous wastes (which bans trade in some waste chemicals and metals) might want to import blacklisted goods in order to recycle them or use them in some manufacturing process. Its goods might be barred by a signatory to the convention. The non-signatory could take the reluctant importer to the WTO, and stand a good chance of winning.

All this might worry environmentalists less if the WTO's dispute-settlement system were as limp as the old GATT's, but in fact it is remarkably effective. If one government believes that another is blocking its imports in breach of WTO rules, it can ask for talks. If these fail to resolve the dispute, the complaining government can ask for a panel of trade officials to adjudicate. If the panel finds the rules have been broken, the "guilty" party is supposed to amend its laws or practice to conform with WTO rules. Appeals are possible, but once a final decision is reached, it can be blocked only by a consensus of WTO members. This is a big change from the old GATT system, under which every member (including guilty parties) had the right of veto. So far, no one has ignored a panel decision, because no one wants to jeopardise the credibility of the system of rule-based trade. But if someone did, the offended party could eventually retaliate with trade sanctions of its own.

The WTO's rules do in fact allow countries to impose trade restrictions for environmental and health reasons. Article XX of the GATT permits trade measures "necessary to protect human, animal or plant life or health ... [or] relating to the conservation of exhaustible natural resources if such measures are made effective in conjunction with restrictions on domestic production or consumption."

However, some supposedly "green" rules are not necessary to protect health or the environment at all, but are protectionist in either intent or effect. America's ban on Venezuelan petrol is one example. The EU's refusal to accept beef treated with hormones is another. There is little scientific evidence to suggest that such meat is any more dangerous than hormone-free beef.

Some greens insist that the WTO has no business sitting in judgment on laws passed by sovereign governments. Yet judging the compatibility of national laws with trade accords is precisely what the WTO's dispute-settlement process—set up with the agreement of all its member states—is there for. Both the disputed cases are examples of governments doing more than they should. Americans can surely make up their own minds on which shrimp to eat, helped if necessary by clear labelling. And if Europeans are happy to eat hormone-treated beef, and science judges it safe, why shouldn't they? John Jackson of Georgetown University Law School, an authority on WTO law, says the hormone case is particularly interesting because: "It's the first to grapple heavily with the question of what scientific evidence a government has to present and the degree of risk [to consumers] it is obliged to negotiate." WTO rules suggest that governments can decide how much risk they will accept in imported food. In effect, says Mr Jackson, the EU decided to run no risk at all. But if governments have so much leeway, they could get away with any import ban, however flimsy its scientific foundations.

A shrimp's a shrimp for a' that

A more important reason why the WTO and the greens are at loggerheads is another GATT rule requiring "like products" to be treated identically. This means that with very few exceptions—eg, goods made by prisoners—countries cannot ban imports because they do not like the way they have been produced: if they could, it would give rise to all sorts of protectionist jiggery-pokery. So WTO panels, like GATT panels before them, have regarded production methods as irrelevant: a shrimp is a shrimp, whether or not the net in which it was caught has a turtle-excluder.

Many environmentalists object. If the WTO rules out all trade sanctions that discriminate between more and less conservationist methods of production, then what chance is there of cleaning up? There should be exceptions to allow countries to favour goods made in less polluting ways.

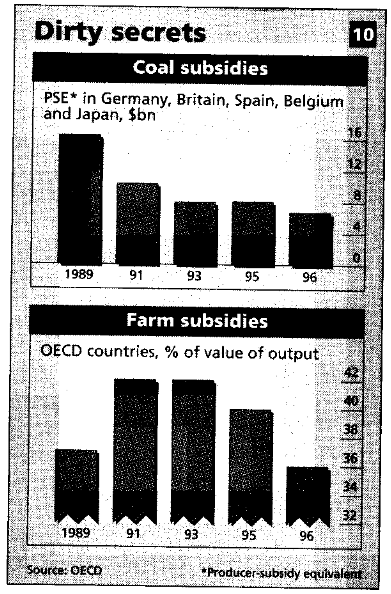
According to Mr Brack, in some circumstances they may be right. Where pollution spans or crosses borders, the threat of trade sanctions can be an efficient way of achieving an environmental goal. The Montreal Protocol is a case in point. Other MEAS might be more effective if their trade clauses were immune from challenge by non-signatories at the WTO.

But this is far from straightforward. Suppose that the signatories to an MEA—to reduce emissions of certain gases, say—were mainly rich countries and the non-signatories were mainly developing ones. The developing countries might be less concerned about reducing pollution, or they might think they were being asked to bear too much of the burden. Would the rich be justified in banning imports from the poor? Clearly any exceptions to Article XX for MEAS would have to be chosen with care.

In any event, where pollution is confined to a single country, the argument for using trade sanctions against it is hard to stand up. Different parts of the world, Mr Brack points out, can tolerate different levels of pollution, depending on climate, the preferences of local people and governments, and existing pollution levels. Imposing the same environmental rules on every country, backed by trade sanctions, would destroy the comparative advantage of many countries, especially developing ones. It would be easy for protectionists to use greenery as an excuse for import restrictions.

Coming out of the shell

The WTO is looking around for ways of accommodating the greens' complaints. For example, it plans to open up its procedures by allowing non-governmental organisations to provide briefs to dispute-settlement panels and to attend hearings. It is already taking more advice from experts: in the shrimp-turtle case, for example, it assembled a clutch of marine biologists. That should help to deflect the environmentalists' charge that the WTO is secretive and lacks know-how.



Changing the WTO's rules, however, is a taller order. In theory, says Mr Jackson, it would be easy to add a paragraph to Article XX to the effect that nothing in the WTO's rules prevents the application of certain MEAS. But he adds: "Politically, I can't see it going through." Such an amendment would have to be approved by three-quarters of all WTO members, and opposition from non-signatories to those MEAS would be robust.

But there are things governments can do that would make trade freer and the planet cleaner at the same time. According to a recent OECD study*, governments continue to support agriculture, energy and transport in ways that damage the environment (see chart 10). Minimum farm prices, for example, encourage farmers to produce too much, using more energy and more chemicals than they should. Coal subsidies encourage power companies to use dirty methods of electricity generation. Such subsidies are already in decline. Speeding their demise would please both free-traders and environmentalists.

* "Improving the Environment through Reducing Subsidies". 1998

Brothers up in arms

How not to enforce labour standards

A FORMER World Bank economist recounts a field trip to Morocco. Her guide led her through the medina to watch people working in miserable conditions, buffing up pots for the tourist trade. Next, they ducked into a workshop lit by a single weak lamp where two men were making moulds from dirt. They went on, and down, into more heat and darkness, until they came to the last circle of this little hell: in a near-lightless room, a dull-eyed boy was shovelling coal into a kiln.

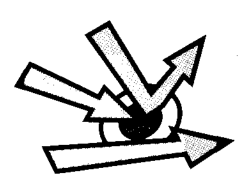
'How long do you work?' asked the economist.
'Ten hours a day, six days a week,' he replied.
'How old are you?'
'Sixteen.'
'And how long have you been working here?'
'Nine years.'

The boy was uneducated. His family, back in his home village, needed money. Sadly, his plight is far from the worst in the developing world, and it is anything but new. Indeed, a century or so ago, that economist's European forebears may well have faced the same choice: work or starve.

Trade unions, backed by some politicians, think they can use international trade as a lever to make things better. Use trade sanctions as a punishment for countries that ignore minimum standards of decency, the argument goes, and they will come to their senses. But the WTO disagrees: its rules do not ban imports made by either slave labour or child labour—only those produced by prison labour.

Some WTO members, notably America, have long wanted to link trade liberalisation and labour standards. Others, especially developing countries, smell protection, and not without reason. American unions have long argued that low wages and labour standards in the third world create "unfair" competition for American workers (see next article). But the WTO points out that labour standards are the domain of the International Labour Office (ILO), another organisation based in Geneva.

The ILO, a tripartite body made up of governments, trade unionists and employers from 173 countries, has been going since 1919. It is quite happy to look after its own patch without help from



Labouring 11

ILO conventions on "core" labour standards

No.	Date	Subject	No. of signatories
29	1930	Forced labour	149
105	1957	Forced labour	132
87	1948	Freedom of association	122
98	1948	Right to organise and collective bargaining	138
100	1951	Equal remuneration	137
111	1958	Discrimination	128
138	1973	Minimum working age	61
		Number that have ratified all seven	**35**

Source: ILO

the WTO. In June it produced a Declaration on Fundamental Principles and Rights at Work which obliges its members "to respect, to promote and to realise" the principles of seven ILO conventions defining core labour standards, even if they have not ratified them (see table 11).

The ILO makes no link between labour standards and trade; indeed its declaration stresses that labour standards should not be used for protectionist purposes. So how will they be enforced? Through shame, hopes the ILO. "In the future," says Michel Hansenne, its director-general, "public opinion will be more important for pushing governments to comply with their commitments." Not good enough, say trade unionists. "The ILO declaration is a great step forward," acknowledges Thea Lee of the American Federation of Labour and Congress of Industrial Organisations (AFL-CIO). "But we'll never see that as a substitute for action in the trade arena. We're not going to give up at the WTO."

The WTO's rules and its dispute-settlement system, trade unionists say, have the bite they are looking for. Bill Jordan, general secretary of the International Confederation of Free Trade Unions (ICFTU), a Brussels-based club of 206 union federations from 141 countries, puts it this way: "We aim to get the world committed to core standards. But we know there's no world government, so we're at a disadvantage. The WTO is the nearest thing we have." The ICFTU wants to see WTO membership made conditional on the observance of core labour standards, certified by the ILO: "If you want to belong to this club," says Mr Jordan, "you have to believe in these standards."

Teeth or gums?

What little information is available suggests that there is no strong link between observance of core labour standards and trade flows, so exporters in developing countries would not suffer much if they adopted the ILO's conventions. By the same token, it seems that workers in rich countries have little to fear from competition with the downtrodden of the developing world.

That is reassuring, but it does not mean that the use of trade measures to enforce core labour standards is a good idea. There is nothing wrong with the intentions behind the standards: civilised people would agree that bonded labour or imprisonment of trade unionists is wicked. But enforcing the standards may not always have the desired effect. If trade unions are recognised, wages in unionised sectors might rise but employment might fall. Displaced workers might be pushed into worse-paid jobs than they had before.

In a paper published last year*, Keith Maskus, an economist at the University of Colorado at Boulder, explains why using trade sanctions to try to improve people's lives may not work. Suppose, he says, that a developing country exports goods made with adult labour, but relies on an input made in an unregulated industry using child workers. Other countries, wishing to discourage the use of child labour, put a tariff on the developing country's goods. Demand for those exports will fall, reducing demand for the adult workers in the industry and cutting their wages. There is also a knock-on decline in demand for its inputs, and therefore the labour of the children making them. So fewer of them work, and their wages fall. Both adult and child employees are worse off.

This could be offset, says Mr Maskus, if the rest of the world recycled its tariff revenue to the target country (or made a contribution from other taxes) in return for a higher minimum working age. The best solution, though, would be not to use trade restrictions at all, but to find other policies that avoid their adverse effects. For instance, children are often put to work because their parents' incomes are too low to make ends meet. So it would help to create more and better-paid jobs for adults—which sounds like a case for freer trade, not more restrictions. Equally, children would be less likely to work if education were more affordable. Subsidising education in developing countries would not only stop some children working; in the long run a more educated workforce would also boost the country's productive potential.

Aware of these pitfalls, some advocates of link-

How best to stop this?

* "Should Core Labour Standards be Imposed Through International Trade Policy?" World Bank Development Research Group, Policy Research Working Paper 1817, August 1997

ing trade and labour are shy of calling for tariffs and import bans. "We don't want to go down the sanctions route," says Stephen Pursey, the ICFTU's chief economist. His tentative suggestion for making the link is that if a country persistently failed to meet the ILO's standards, it could be denied the right to bring cases to the WTO's dispute-settlement system. But without the risk of a dispute-settlement case, other countries would feel free to maintain whatever trade barriers they liked against imports from the recalcitrant country, or even to put up some new ones.

The losers would be exporters from the punished country, be they good or bad employers, along with their workers. Better by far to stick with the ILO. If trade unions and their allies in government try to borrow the WTO's teeth, they may find that they bite in the wrong place—if at all.

The wages of fear

Are poor countries pinching the rich ones' jobs?

UNTIL the recent jitters, the 1990s seemed to be a golden age for America's economy. Growth was high, inflation and unemployment low. All the same, though, plenty of Americans were wondering why the economy's health was not reflected in their pay packets. Indeed, many Americans have seen little improvement in their living standards in the past quarter-century. After allowing for inflation, average hourly earnings are now lower than they were in 1973—although thanks to increased fringe benefits, average annual earnings have actually risen, according to Susan Collins, an economist at Georgetown University*. At the same time, earnings inequality has increased strikingly. Between 1973 and 1993, the real pay of men 10% of the way up the earnings distribution fell by 21%; for men 10% from the top, it rose by 8%. Women did a little better at the bottom, where earnings went up by 3%, but much better at the top, where they rose by 29%.

In European countries, too, poorer workers are feeling the pinch. Like America, Britain has seen an increase in earnings inequality. In continental Europe, where wages are less flexible, pay differentials have not widened, but unemployment has risen steeply. Some politicians and union leaders, and a few economists, argue that freer trade with developing countries is to blame. This is being said on both sides of the Atlantic, but more loudly in America, especially since the passage of NAFTA. In 1973, only about one-sixth of America's manufacturing imports came from developing countries; now the proportion is one-third. To many people, it seems that American workers' pay is being cut by competition with cheap foreign labour.

But it is not as simple as that. Wages reflect productivity, which implies two things. First, Americans' wage growth has slowed down since 1973 because productivity growth has been lower. Second, the gap between wages in America and wages in developing countries, on average, reflects Americans' higher productivity. So although Americans generally have much fatter pay packets than workers in developing countries, they cost no more to employ per unit of output, and often less. Moreover, says Ms Collins, although America now buys a slightly larger share of its imports from developing countries than it did 25 years ago, average wages in its supplier countries have gone up relative to wages in America, because wages in developing countries have risen much faster than those in rich countries (see chart 12).

Those same trade unionists and politicians argue that, if some Americans are losing out from freer trade, America should put up barriers against imports from poorer countries. Trade with Mexico and China is a favourite target. Yet import barriers would make Americans as a whole worse off: American companies would be under less pressure to make goods as cheaply as they can, and resources would be wasted on making things that could be bought more cheaply from abroad. Everything would get more expensive—and poor Americans as well as rich ones would have to stump up.

A price to pay

Nevertheless, there are good reasons why freer trade might hurt some of America's poorer workers. The whole point of free trade is that it makes countries specialise in industries where they have a comparative advantage; so when trade barriers are removed, resources are shifted into those industries, and away from less productive uses. In America, although this change undoubtedly benefits the economy as a whole, it may work to the disadvantage of unskilled, and therefore low-paid, workers.

As any economist will tell you, this phenomenon can be explained by the Stolper-Samuelson theorem, which says that a fall in the price of a good—say, as a result of a tariff cut—reduces the pay of the type of labour most heavily used in making it. So a fall in American tariffs on imports from Mexico of goods that use low-skilled labour relatively intensively will cut the wages of low-skilled Americans.

Do the facts fit the theory? Economists have concentrated on explaining the increase in the "skill premium", measured in most studies by the ratio of the pay of workers with college degrees to that of high-school graduates. In the 1970s this was around 1.3-1.4, but since 1980 it has risen fairly steadily, to about 1.7 now. Some studies have concluded that trade explains a lot of the skill premium, but most find the effect of trade is rather modest, accounting for perhaps one-fifth of the rise in the premium. This is partly because the evidence on prices does not quite fit the story: the relative prices of goods in low-skill industries did not fall in the 1980s, when

* This article draws on a book edited by Susan M. Collins, "Imports, Exports and the American Worker". The Brookings Institution Press, Washington, DC, 1998

the skill premium rose sharply, but they probably did in the 1970s, when it was constant.

Other factors seem to have been more important. Richard Freeman, of Harvard University, reckons that immigration has probably had a far bigger effect on the market for low-skilled labour than trade. Workers in many service industries, from barbers to taxi drivers, are fairly well insulated from international trade, but will meet hot competition from immigrants.

Most important of all seem to have been advances in technology, which have favoured the better-educated at the expense of the rest. Why only "seem"? Because the effects of technical change are hard to measure directly. Most models explain as much as they can of the change in the skill premium in terms of price changes, trade flows, immigration and whatnot, leaving a large chunk unexplained. That residual is then attributed mainly to changes in technology.

The effects of changes in technology and changes in trade are hard to unravel. Suppose that a foreign company discovers some new cost-cutting technique for making widgets, which brings down the price of widget imports into America. If the wages paid by its American competitors fall as a result, are the workers victims of trade or technology?

If trade has a smallish effect on the skill premium, it has an even smaller effect on wage inequality as a whole, says Ms Collins. Only about one-third of the increase in inequality can be put down to differences between workers—whether in education, race or sex. So at most only 7% of the increase in wage inequality can be blamed on trade.

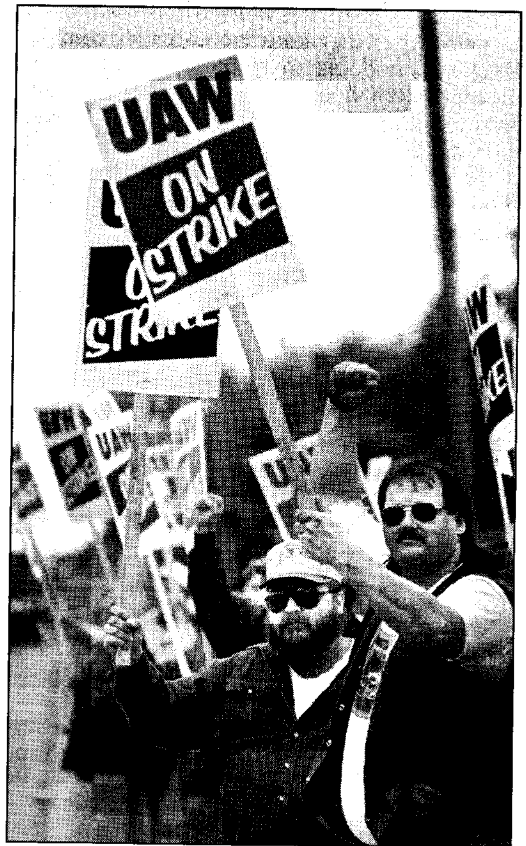
Never mind the economics, count the votes

None of this, however, has stopped freer trade from becoming a political problem. Is it always possible to find anecdotes about jobs lost to foreign competition, or of workers swallowing pay cuts to stop their bosses from moving their factory to Mexico. Moreover, the benefits of trade tend to be more spread out than the losses. The local effects of a factory closure are only too obvious; the across-the-board effects of greater consumer spending power generated by cheaper imports, or of higher productivity brought about by increased competition, are far less evident.

One way of getting round these political problems is to compensate the losers from freer trade. In practice, that means those whose jobs disappear rather than those who merely suffer pay cuts. Since freer trade should benefit the economy as a whole, some of that benefit could be channelled to the losers through the tax and welfare systems.

This idea has, in fact, been put into practice in America since the Trade Expansion Act of 1962. Workers displaced by foreign trade can apply for Trade Adjustment Assistance (TAA). This extends unemployment insurance payments for up to a year beyond the usual six-month period, provided that claimants take part in a training programme. Since 1974, about 2m workers have been certified as eligible for TAA. The number taking it up has been much lower, because many of the workers have found other jobs.

In a recent book, "Globaphobia"*, four American economists—Gary Burtless, Robert Lawrence, Robert Litan and Robert Shapiro—say that TAA should be reformed. The payments go on for too long, removing the incentive to get a job quickly. Workers who find a new job at lower pay should also be compensated, to give them an incentive to work for less. And the training does little to fit workers for new jobs, so it should be scrapped.



At the losing end

All this would be an improvement on the current system, but two problems remain. First, how can the losers from trade be identified? Just think of the difficulties of unravelling the effects of technology and tariff cuts; then remember that trade is about a lot more than border measures. What about deregulation to allow foreign ownership of American airlines, shipping or television stations; or recognition of European drug-testing regimes, or of foreign medical qualifications?

Second, what is so special about trade? It is just one of many forces that send resources whizzing around the economy. It seems odd to pay a worker compensation because his firm has succumbed to competition from imports, but give him nothing if it has been put out of business by a company up the road, or failed to adapt to changes in technology or in customers' tastes. Paying out in this way seems to support protectionists' contention that trade is a blight on employment like no other.

The four authors are aware of both these drawbacks. They suggest getting round the first problem by limiting compensation to victims of specific trade agreements, and by allowing Congress to

* Published by the Brookings Institution Press, the Progressive Policy Institute and the Twentieth Century Fund

specify the industries in which compensation will be paid. Yet as they note, the extremely complex Uruguay round triggered no special adjustment measures, even though it will have a far greater effect on the American economy than NAFTA, which did prompt such measures. The second point—that trade is just one of many economic forces, and should not be singled out—is unanswerable.

But perhaps such carping misses the point. Adjustment programmes are political devices, not economic ones. And for free-traders, the most bewildering fact about the American economy is that, despite all the stability and success in recent years, Americans have remained nervous about freer trade. So have plenty of their elected representatives. Why?

Slow road to fast-track

Does it matter?

WHEN Bill Clinton addressed the WTO in Geneva last May, he issued an invitation to trade ministers: next year, come to America. Some governments hope that this meeting, due to start on November 30th 1999, will be the overture to a new round of global trade talks. The European Union's Sir Leon Brittan has long been calling for a "millennium round". Yet the Clinton administration has been shy of endorsing a new round. Why?

America's reticence is partly tactical. In the past, the Americans argue, rounds have dragged on and on—the Uruguay round lasted an epic seven-and-a-half years—because nothing is decided until everything is decided. So before starting a new round, American officials want to set a timetable for completing talks on different subjects and implementing their results.

However, there is another reason for America's shyness. Mr Clinton does not have "fast-track" negotiating authority from Congress, which has the constitutional right to "regulate commerce with foreign nations and between the several states". Fast-track authority allows a president to negotiate trade agreements and ask Congress to pass the necessary legislation within 90 working days and without amendment. Without fast-track, trade agreements can be put before Congress as ordinary bills, which can be amended, or they can be presented as treaties. But treaties require approval by two-thirds of the Senate—where they can also be amended or held up indefinitely by the foreign-affairs committee. The beauty of fast-track authority is that it prevents Congress from rewriting trade deals once the president has signed them, and therefore boosts his credibility in trade negotiations.

For most of the past quarter-century, presidents have had few problems winning fast-track authority. From free-traders' point of view, that has been immensely useful. It has helped to push through five big trade agreements: the Tokyo round of GATT, free-trade agreements with Israel and Canada, NAFTA, and the Uruguay round, the last two during Mr Clinton's first term in the White House. But since 1994 Mr Clinton has been without fast-track authority. Last autumn he was on the point of formally asking for it, but when it became clear that he would not get it no vote was taken.

A persistent headache

Curmudgeonly Congress

Given the rude health of the American economy over the past few years, the administration's failure to win fast-track authority seems remarkable. It is more surprising still in view of Mr Clinton's success, in his first year in office, in squeezing NAFTA through Congress by forging a coalition between Democrats and Republicans.

So why has he failed? In essence, because Congress is deeply divided over what a fast-track bill should say about labour standards and the environment. Most Republicans think that trade should not be linked to these issues at all. Most Democrats think it should.

Since the Democrats are in a minority in both houses, there is no chance in this Congress of passing a bill encapsulating their ideas on a trade mandate. Hence Mr Clinton's attempt last year to win fast-track authority on the Republicans' terms. Such a bill would have excluded clauses on labour and the environment from fast-track treatment. However, despite the Republican majority the bill could not pass without some Democrat votes because not all Republicans support free trade.

Mr Clinton failed to persuade members of his own party to support a "Republican" bill. "The Democrats think Clinton left them a long time ago," says Mac Destler, a specialist in American trade politics at the University of Maryland. Paradoxically, this lack of trust has its roots in the president's success in building a pro-NAFTA coalition in 1993. At the time most Democrats were opposed to the agreement, which Mr Clinton inherited from George Bush. They worried that American workers would be hurt by freer trade with Mexico because Mexico's looser labour and environmental standards would give it an unfair advantage. Mr Clinton put their minds at rest by adding side accords on labour and the environment. And to win over Hispanic Democrats, he came up with a North American Development Bank (NADBank) to finance environmental projects on the Mexican border and to help workers who lost jobs to new competition from Canada and Mexico. That brought enough Democrats on board.

Four years on, however, those Democrats felt short-changed. The labour and environment side accords never amounted to much, merely obliging each NAFTA country to respect its own laws. The NADBank has, until recently, done little. And among the losers from NAFTA, Hispanics stood out: Raul Hinojosa-Ojeda, of the University of California at Los Angeles, reckons that many Mexican immigrants who had headed north in search of work saw jobs move in the opposite direction. Thus last year, when Mr Clinton was looking for fast-track votes, congressional Democrats insisted that they could not support a bill denying fast-track treatment to labour and environment clauses. It was weaker in that respect, they said, than the authority given to Mr Bush.

In this Congress, fast-track is not quite dead. Newt Gingrich, the Speaker of the House of Representatives, is pushing for a vote on last year's aborted bill. This would simultaneously endear him to the farm lobby, which is keen on fast-track, and make mischief for the president, who would rather wait until 1999. Mr Clinton has no wish to advertise his own party's divisions on trade so soon before congressional elections, and for now would rather use such political capital as he still has on the equally fraught issue of financing the International Monetary Fund. And without the administration's backing, a vote on fast-track is unlikely to be carried.

The president's chances of winning fast-track in the next Congress look better, if still not good. If the balance between the parties after the mid-term elections later this autumn stays much the same as it is now, he may try again to find some wording that will satisfy enough Republicans and enough Democrats. This looks his best bet: Hispanic Democrats, in particular, have sounded more emollient in recent months, now that the NADBank has at last started disbursing money.

Next year, some time, never?

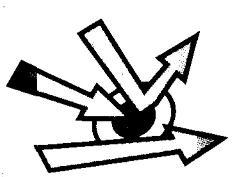
How much do these congressional shenanigans matter to getting trade agreements into place? Not much, says the administration. Charlene Barshefsky, the United States trade representative, reels off a long list of all the deals that have been struck without fast-track, including the WTO's agreements on telecommunications, financial services and information technology. The Europeans also say they are not fussed: "You need fast-track to complete the round, not to start it," explains Sir Leon. Ms Barshefsky and Sir Leon seem to have precedent on their side. The Tokyo round began in 1973, but Congress did not give the administration fast-track authority until 15 months later. And when President Reagan was granted fast-track in 1988, the Uruguay round had already been going for two years.

The difference, says Craig VanGrasstek, a Washington trade-politics expert, is that in 1973 and 1986 there was not much doubt that negotiating authority would be granted, nor about the likely terms. Now no one really knows. In the mid-1980s, there was a congressional coalition in favour of negotiating trade agreements on the then-new issues of services trade and intellectual property, where American exporters had plenty to gain and domestic firms had little to fear from foreign competition. But now labour standards and the environment are so divisive that building a new coalition may prove impossible.

Barshefsky: fast-track is not a worry

In the absence of fast-track authority, the president has limited scope to strike new deals without asking Congress's approval. In 14 sectors where America made "zero-for-zero" tariff offers in the Uruguay round, the president is still free to cut tariffs in WTO negotiations. These include farm equipment, electronics, drugs, steel and toys. This freedom is being used in talks on tariff reductions by APEC countries, which are meant to apply to imports from non-APEC countries as well. But in most of the sectors under discussion, including energy and fish, the president does not have authority to cut tariffs.

In essence, he is free to make deals only if they require no changes in American law (which would require Congress's permission). This proved a serious constraint to America in the WTO talks on financial services and telecommunications, says Mr VanGrasstek. With more freedom to offer concessions of their own, he suggests, the Americans might have been able to prise more out of their negotiating partners. America's limited room for manoeuvre will also prove unhelpful in future talks. Chile has already made it clear that it is not prepared to discuss joining NAFTA until fast-track is in place (but has meanwhile struck deals with Canada and Mexico). Small beer, perhaps; but nevertheless a blow to Mr Clinton's planned Free-Trade Area of the Americas, and a sign that WTO talks without fast-track could be sticky.



India's hesitation

The trouble with free trade

IT IS not only in America and other rich countries that free trade is politically contentious. In developing countries the arguments against free trade often sound very similar to those in the rich world. Hot competition from foreigners, fear both rich and poor countries, will pre-empt sales and demolish jobs. The only difference is the perceived nature of the competition. The developed countries worry about the rock-bottom cost of labour on offer in the third world, whereas the developing countries are convinced that their western rivals' ruthless efficiency will put them out of business.

Fortunately for the cause of free trade, the protectionists have lost more battles, in both developing and developed countries, than they have won in recent years. In fact, the recent willingness of the developing world to embrace freer trade has been more remarkable than the continuing liberalisation in richer countries. In 1980, developing countries made up about half the GATT's membership. With more than 40 joining the club since, they now make up two-thirds of the WTO's roll.

Ready for liberalisation?

Yet the arguments continue. Nowhere, perhaps, is the tension between a protectionist past and a liberalising present more acute than in India. In few places does it matter more. India, with more than 900m people, is the second most populous country on earth. Its GDP, however, is not much bigger than the Netherlands'. Many of its people live in terrible poverty, for which decades of protectionism are partly to blame.

If signs of a return to economic isolation are going to surface anywhere in the developing world, India might be the place. Although a founder member of GATT, until 1991 its economy was virtually closed. Stifling protection and domestic controls had created a South Asian mouse next to East Asia's tigers. In the early 1990s a number of exciting things happened. The government slashed tariffs, made it easier for foreigners to invest in India and began to loosen some of the choking domestic controls. Since then, however, the pace of progress has slowed. In 1996 the government imposed an extra tariff of 5%. And this year its successor, headed by the nationalist Bharatiya Janata Party (BJP), raised tariffs again. Is India turning inwards?

More, please

Probably not, but its reforms have served to highlight how much more remains to be done. Before reforms began, virtually all imports into India had to be licensed. Now more than two-thirds of tariff lines can be imported without licences; around 10% require special import licences, which expose Indian companies to limited foreign competition before licence obligations are removed altogether.

Tariffs have come down a long way: in 1993, the WTO estimates, average tariffs (measured by a simple, unweighted average across all tariff lines) were 71%, with a peak of 340%; by the time the WTO reviewed India's trade policies in April this year, they were down to 35%. Moreover, those averages hide some dizzy extremes. Before reforms started, estimates O.P. Lohia, managing director of Indo Rama, a textile company based in Delhi, import duties on synthetic fibres were of the order of 200%; and once special taxes had been added, the effective figure was more like 500%. Now he pays 35% in import duties, and another 35% in other taxes.

"You feel a little better," says Mr Lohia. "But this is still very high." And indeed these rates, although low by India's historic standards, are pretty steep by most other countries' present-day standards. Some sectors have remained untouched by reform. Consumer goods are still covered by licences, although India has proposed a timetable for phasing them out. Agriculture, as in many other countries, is mollycoddled. And India's textile and clothing industry, which moans loudly (and with good reason) about the trade barriers maintained by developed countries, remains heavily protected by its own government. Despite these shortcomings, says Mr Lohia, "Any Indian will feel we've done a great job."

Too great for some. After being protected so long, some Indian businesses found that they were poorly equipped to deal with foreign competition. "If you have to earn your bread through the sweat of your brow, it's harder than through rent-seeking," says Manmohan Singh, who as finance minister was the architect of India's reforms. Even before Mr Singh left office in 1996, the complaints of business and organised labour became more vocal, and the pace of reform slowed. "We're a democracy. We're not like China, where Deng Xiaoping could say what goes," he explains.

The arrival of a BJP-led government in March looked like a setback for freer trade. True, the BJP has long called for the removal of government controls on the domestic economy; but it was also backed by some of the companies that were calling for more external protection. The party is associated with the idea of *swadeshi*, or self-reliance. That might mean deregulation with some preference for Indian companies, if not outright protection. Moreover, soon after taking office the party took two steps away from trade liberalisation. First it tightened India's anti-dumping procedures; then, in the budget in June, the finance minister, Yashwant Sinha, imposed an extra tariff of 4%. In fact, says Arvind Panagariya of the University of Maryland, this raised prices by 6%, because it was applied after customs duty and excise taxes. Combined with the previous government's impost, this means that tariffs have risen by 11 percentage points since 1996.

Braking, not turning?

However, it is too early to conclude that India is returning to protection. For a start, the government insists that tariffs were increased to raise revenue, not to protect Indian business. Next year, says N.N. Lakhanpal, the director-general of foreign trade, the government will cut tariffs—not just back to where they were before this year's increase, but beyond. Cynics mutter that this is just a variant of jam tomorrow, but for the moment no one really knows.

Second, it is reassuringly easy to find optimistic Indian businessmen outside the BJP's charmed circle. Sunil Mittal of Bharti Enterprises, which provides telecommunications services and makes telecoms equipment, is one. He describes his company as "a product of liberalisation"—the state monopoly in telecoms ended in 1992—and himself as "generally positive". Indo Rama's Mr Lohia is convinced that the recent increases will be reversed.

Third, the government continues to encourage foreign direct investment. In July it put forward a plan allowing foreign companies to take stakes of up to 26% in Indian insurance companies, having resisted opening the insurance market to foreigners in the past. The proposal angered supporters of the *swadeshi* policy. "Automatic" approval of foreign investment with pre-set limits of up to 100% was extended to more sectors of industry.

Yet while tariffs remain so high, and both the tariff and the tax system are riddled with anomalies, this is no time to pause. In a fine example of the law of unintended consequences, Mr Mittal says that it is cheaper for Bharti, based in Delhi, to import components from Hong Kong than to buy them from a supplier in the capital. The company would pay no tariffs on the imports, but would have to pay a tax on the local goods.

Such nonsenses mean that India is wasting resources on making things that it could buy more cheaply from abroad, and it is handicapping its own producers by forcing them to pay over the odds for their supplies. It is also taking money out of consumers' pockets by imposing high tariffs and licensing restrictions on consumer goods. That money could be better spent elsewhere.

Reforms at the border, however, are not enough. India is a striking example of the close interconnection between domestic and external reforms. The government has vowed to bring the country's infrastructure up to date, but power cuts remain daily events, and transporting goods from northern India to Mumbai, the biggest port, takes weeks. Laws inherited from the British prevent companies from shedding workers or closing down.

The most telling evidence of the cost of delaying reform is the sheer effort companies have to expend to cope with the country's labyrinthine bureaucracy. Foreign investors continue to seek permission from the Foreign Investment Promotion Board, even though their plans are covered by the automatic approvals system. One Indian manager for a multinational company explains that foreign managers lack the skills needed to operate Indian labour law. For example, he says, non-essential staff should not be hired "permanently", because that makes them impossible to sack. But when technology changes, so that once-essential staff become not only expendable but redundant, even Indian managers' ingenuity is tested.

Some Indian companies complain that, now that the economy is growing more slowly than in the early 1990s, they find it harder to face competition. A reforming government would say: too bad. There are plenty of Indian companies that thrive on it. Indian consumers, for their part, think it is wonderful: compare the average Delhi taxi (technology circa 1955) with a new, air-conditioned version, courtesy of foreign investors.

And the macroeconomic picture? It was trade liberalisation, argues Bibek Debroy of the Rajiv Gandhi Institute for Contemporary Studies, that got exports going. "When you have been doing 20,000 things wrong, even if you do a few right, you get a big growth rate initially." Time to do a few more things right?

Seconds out

For the next round

WHEN Peter Sutherland, the GATT's last director-general, brought down the gavel on the Uruguay round in December 1993, some people wondered whether there would ever be another such all-encompassing round of trade talks. The thought may have been prompted by jaw-ache after more than seven years of often exasperating negotiations. More importantly, however, the Uruguay round came with a built-in programme of future work. Talks on four areas of services trade remained unfinished; new talks on agriculture were already set for 1999; and more negotiations on services were scheduled for 2000.

Since then, the WTO has proved itself reasonably adept at doing business outside trade rounds. Two lots of left-over services talks—on telecoms and financial services—eventually succeeded. The information-technology agreement was all but sealed in Singapore in December 1996, within a year of starting. And there is a fair chance that Mr Clinton's plea for allowing electronic commerce to develop without barriers will be heeded.

Yet next autumn, when trade ministers meet in America for the WTO's next conference, the most important decision they will face will probably be whether to launch a new round. Their answer should be an unreserved yes. There are at least four reasons why.

The first is that trade negotiations seem to work best when a range of issues can be bundled together. Single-issue negotiations on services have not been an unqualified success. Negotiations on maritime services were sunk by the Americans before they left port. Rich-country indifference also dashed any hopes of an agreement on the "movement of natural persons", trade-speak for the temporary employment of foreign workers. A round that ties together a complex package of issues offers a better chance of striking deals: concessions in one area can be traded for advances in another.

Second, a long agenda is building up. In addition to services and agriculture, there are manufacturing tariffs, the treatment of foreign investors and competition policy. Sooner or later, too, WTO members will have to find some way of resolving the conflict between the organisation's rules and those of multilateral environmental agreements.

A round covering all this would go some way to completing the huge shift in trade rules begun in the Uruguay round. These rules now recognise that free trade amounts to far more than the removal of barriers to trade in goods. But in services and investment, foreign suppliers are often still a long way from getting "national treatment". Some agreement on antitrust law would help to stop private trade barriers replacing official ones.

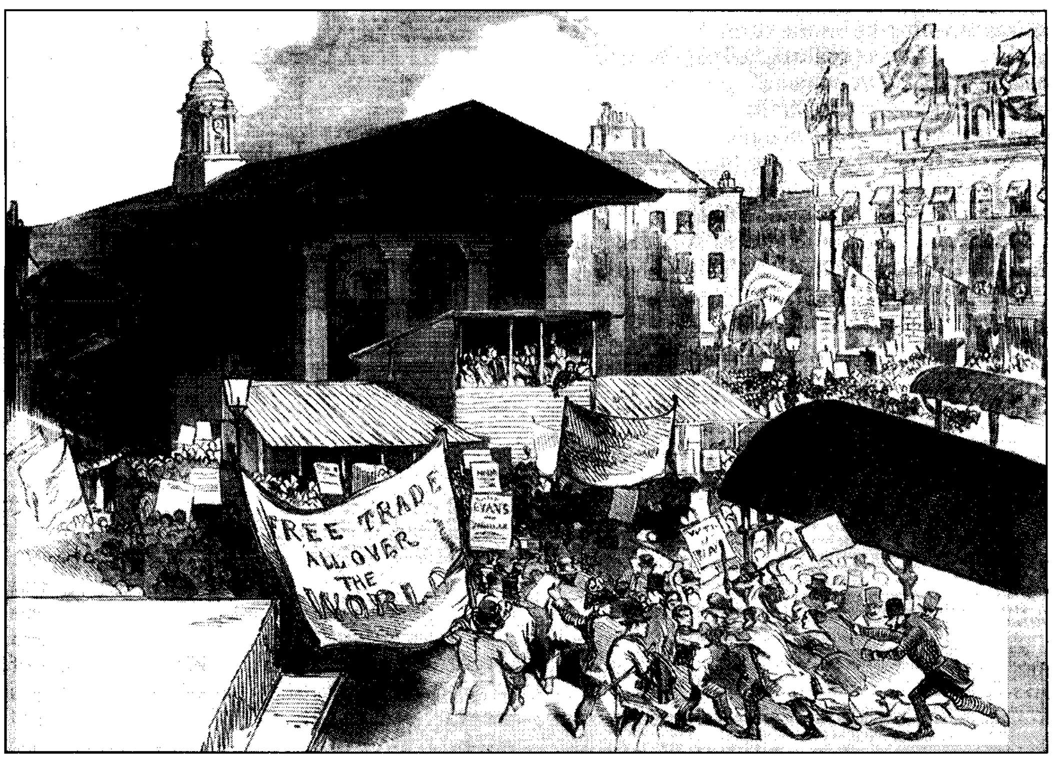
The third reason is that if the WTO does not come to grips with the new issues, regional trade organisations will continue to go their own way. In some cases that may be fine, but in others it may get in the way. If global liberalisation were continuing apace, there would be less need to worry about the way regional agreements distort trade.

Why now is a good time

The fourth and most important reason for a new trade round is the parlous state of the world economy. This argument may not be immediately obvious. The deep recession in many Asian economies and the turmoil in world financial markets may well spread to the trading system. Already, Americans and Europeans are struggling to sell their wares in depressed Asia, and are losing markets to Asian goods made far more competitive by huge devaluations. Some westerners may, therefore, be tempted to call for curbs on trade. And if financial markets crash, or the world economy moves into recession, free markets may seem less of a good idea than they did a couple of years ago.

Yet these are arguments not for closing the shutters, but for opening them more widely. In the 1930s, protection turned recession into rout. If the same remedy were adopted, history could repeat itself in the 1990s. Freer trade, on the other hand, offers the prospect of earlier recovery.

Helpfully, WTO commitments bind governments, up to a point, to keeping markets open, come rain or come shine. Moreover, this would not be the first time that a trade round started in turbulent times. Fred Bergsten, of the Institute for International Economics, points out that the Tokyo round was launched in 1973, in the middle of the first oil crisis; and the preliminaries for the Uruguay round came in the wake of the Latin American debt crisis. Launching a new round in 1999 would be a signal that governments are still committed to open markets—and understand that the prosperity of their peoples depends on them.



If at first you don't succeed, try, try again